BEFORE

THE PUBLIC SERVICE COMMISSION OF

SOUTH CAROLINA

DOCKET NO. 92-271-C - ORDER NO. 92-1060

JANUARY 29, 1993

IN RE: Application of United Telephone Company of the Carolinas to Avail Itself of Incentive Regulation.	)))))	ORDER APPROVING INCENTIVE REGULATION PLAN FOR UNITED TELEPHONE COMPANY OF THE CAROLINAS

I.

INTRODUCTION

This matter comes before the Public Service Commission of South Carolina (the Commission) by way of an Application filed on May 14, 1992, by United Telephone Company of the Carolinas (United or the Company) whereby the Company seeks approval of a plan for incentive regulation of its operations in South Carolina and establishment of a rate of return range in which the Company may operate. According to the Company's application, approval of this request would allow United further incentive to invest in new technology, more rapidly market new products and services, improve productivity, and reduce the cost of service. United has requested that, based on twelve months ending December 31, 1991, a benchmark rate of return of 13.75% be established.

The Commission has established a general framework under which a local exchange company (LEC) in South Carolina may apply to the Commission for incentive regulation of its intrastate operations by

Order Nos. 90-849 and 90-1009 in Docket No. 90-266-C.[1] In Order No. 90-849, the Commission found that, in a generic sense, there is competition for the services provided by the LEC's in South Carolina sufficient to warrant consideration of a change in the traditional regulatory methodology. The Commission also found that there were benefits to both the public and the LEC's in adopting some form of incentive regulation and that any potential risks could be dealt with on a case-by-case basis when a particular LEC applied for approval of an incentive regulation plan. The Commission further found that any incentive regulation plan adopted would be optional for the LEC's, last for a trial period of three years, that the LEC would be required to maintain its quality of service standards, and that the Commission would adopt the earnings sharing plan as set forth in that Order.

Order No. 90-1009 clarified certain aspects of Order No. 90-849. Through Order Nos. 90-849 and 90-1009 the Commission implemented a plan with the following parameters: 1) upon approval of a LEC to enter incentive regulation, the Commission would establish a benchmark rate of return; 2) if the LEC earned 100 basis points above or below the benchmark return ("the threshold" or "the floor," respectively), it would retain those earnings or losses; 3) earnings between 100 and 250 ("the ceiling") basis points above the benchmark would be divided evenly between the LEC

1. These Orders are currently on appeal to the South Carolina Supreme Court by the Consumer Advocate and the South Carolina Cable Television Association.

and the customers; 4) the Commission would determine the appropriate method by which to divide these earnings between the LEC and the customer at the time the situation arises; 5) all earnings over 250 basis points above the benchmark would be returned to the customer; 6) if the LEC earned 100 basis points or more below the benchmark return ("the floor"), it could file for traditional rate relief. By these Orders the Commission determined it would annually audit the earnings of any LEC opting under the earnings sharing plan and compare certain efficiency guidelines for each year in the plan to determine the impact of incentive regulation on the LEC. The Commission noted it would exclude exogenous factors from its review of a LEC's performance under incentive regulation.

Following public notice, a hearing was commenced on October 28, 1992, in the Commission's Hearing Room, 111 Doctors Circle, Columbia, South Carolina, with the Honorable Henry G. Yonce, Chairman, presiding. A number of parties intervened in this proceeding and were represented by counsel. Elliott F. Elam, Esquire, represented the South Carolina Department of Consumer Affairs (the Consumer Advocate). AT&T of the Southern States (AT&T) was represented by Francis P. Mood, Esquire, and Roger A. Briney, Esquire. The Company was represented by William F. Austin, Esquire, and James B. Wright, Esquire. The Commission Staff was represented by Gayle B. Nichols, Staff Counsel.

The hearing in this docket included testimony from eleven (11) witnesses. For United, witness Thomas W. Sokol was the primary witness on incentive regulation, while witnesses Thomas J. Geller and John D. Quackenbush testified on accounting and rate of return issues. Testimony on incentive regulation in general was rendered by Gary E. Walsh and James M. McDaniel for the Commission Staff, Allen G. Buckalew for the Consumer Advocate, and James Mertz for AT&T. Witnesses testifying on the issues of accounting and rate of return included Philip E. Miller and John B. Legler, sponsored by the Consumer Advocate, and Thomas L. Ellison, and Dr. James E. Spearman, on behalf of the Commission Staff.

II.

WHETHER UNITED SHOULD BE REGULATED UNDER INCENTIVE REGULATION ESTABLISHED IN DOCKET NO. 90-266-C

During the proceeding, Mr. Sokol testified on behalf of United. Mr. Sokol explained that through its high quality of service and low cost of doing business, United was worthy of entering the Commission's incentive regulation plan. In addition, he testified that the increasing competitive environment for telecommunications services in South Carolina required a change in the form of regulation for United. Mr. Sokol described in detail the specific competitive forces experienced by United.

James Mertz testified on behalf of AT&T. Mr. Mertz explained that AT&T was not opposed to the Commission approving United's request to enter into incentive regulation. However, Mr. Mertz testified that the Commission should adopt for United the incentive regulation plans already approved for Southern Bell Telephone and Telegraph Company and GTE South, Incorporated (GTE).

Allen G. Buckalew testified on behalf of the Consumer Advocate. Mr. Buckalew testified that because United provides service in rural areas of South Carolina, unlike Southern Bell and GTE, it is not subject to the competitive forces which are necessary for a properly-operating incentive regulation plan. Mr. Buckalew explained, however, that should the Commission allow United to enter incentive regulation, certain requirements should be ordered.[2]

In Order No. 90-849, the Commission stated: "[f]or the purposes of this proceeding then [Docket No. 90-266-C, Generic Proceeding to Consider Intrastate Incentive Regulation], the Commission finds that there is sufficient competition to warrant consideration of a change in the traditional regulatory methodology." Order No. 90-849, p. 5. In Order No. 90-1009, the Commission stated that "competition exists to such an extent that every LEC, as a group, is affected by competition." Order No. 90-1009, p. 7. The Commission's finding of sufficient competition in the Generic Docket (Docket No. 90-266-C) to warrant a change in the traditional regulatory methodology does not put the burden on an individual LEC applying for incentive regulation treatment to prove again the existence and impact of competition on its own operations. By establishing an earnings sharing plan, the Commission affirmatively and with finality determined, *inter alia*, that all LEC's were impacted by competition. The Commission finds

2. These requirements are specifically addressed under the Earnings Sharing Plan portion of this Order.

that it is not necessary to quantify the level of competition or the loss of revenues. The Generic Proceeding determined the competition issue, and neither Order No. 90-849 nor Order No. 90-1009 required further showing by any LEC of the effects of competition.

Nonetheless, Company witness Sokol supported the impact of competition on United's operations. Mr. Sokol testified as follows:

> ....It has been stated on many occasions that competition for yellow pages, operator services, and coin telephone has caused significant competitive encroachments in South Carolina. However, while United Telephone Company of the Carolinas has experienced significant competitive activity in these businesses, I would like to also demonstrate the extent of competition in our South Carolina service territory in the toll and access portion of our business. Toll and access revenues represent 39.7% of United Telephone Company of the Carolinas' total operating revenues for the 12 months ending December 31, 1991. I believe my empirical data will prove conclusively that the competition in these two areas is active. (TR. Vol. 1, p. 12, line 18 - p. 13, line 7.)
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> Beginning in January 1989 through mid-year 1991, United Telephone Company of the Carolinas lost 8,295,362 minutes of use or 3.75% of the minutes that were previously switched over our network. These minutes represent traffic that, prior to this time, had been switched totally by United Telephone Company of the Carolinas. This specific competitive loss occurs when the various interexchange carriers go to end users in our operating territory and suggested [sic] that they order T-1 type service from the end users' location to the point of presence of the interexchange carriers. These customers represent some of the largest business customers in United's operating territory. For example, of the 8,295,362 minutes that were lost, 2,516,798 were lost in August of 1989 from a large seed company. Another 1,612,265 minutes were lost in October of 1989 when a large medical facility took their MTS, WATS, and 800 traffic from United Telephone Company of the Carolinas to AT&T. Another 964,744 minutes were lost in October of 1989 when another large corporation took

their MTS, WATS, and 800 traffic from United Telephone Company of the Carolinas over to MCI. It should be noted once these minutes of use were taken from our network, we can assume the minutes lost in subsequent years were as great or greater than those minutes that I have identified for you. I believe that the factual information above is a dramatic example of services bypass that has occurred and has taken switched access and toll revenues away from United Telephone Company of the Carolinas. When these customers, that I noted above, began utilizing high capacity T-1 special access services to connect their location to that of the interexchange carrier, this allowed the interexchange carrier to compensate United based on special access charges versus a per minute of use charge. For large telecommunications users there is a tremendous economic incentive for interexchange carriers to provision these direct connections. (TR. Vol. 1, p. 13, line 1 - p. 14, line 21.)

Much of the above mentioned reduction to United Telephone Company of the Carolinas' revenue streams occurred when the customer was persuaded to order dedicated facilities from United out to the point of presence of the interexchange carrier. We believe United Telephone Company of the Carolinas is extremely vulnerable to further transport bypass by the various alternate access providers also known as competitive access providers. These competitive access providers will first displace the connections provided by the telephone company from the large customers' location to the interexchange carriers' point of presence. United Telephone Company of the Carolinas currently has a significant share of their total transport revenues linked to artificially inflated rate elements. Transport revenues represent approximately 14% of the total operating revenues of United Telephone Company of the Carolinas. We believe the competitive threat from alternate access providers is real for the following reasons:

- regulatory doors are opening to alternative access providers through interconnection in states like Illinois, New York, and Massachusetts.

- end users continue to demand diversity and high speed services.

- competitive access providers offer rates that are approximately 10% below United's DS-1 transport rates.

> For these reasons, we have concluded that transport revenue for United Telephone Company is at risk if alternative access carriers would build their own facilities in South Carolina where economically feasible. As alternate access providers enter the market, our special and switched access revenue streams are vulnerable. I think it can be safely said as these revenue streams leave the local exchange telephone company, it clearly creates a situation where more and more pressure for local rate increases will fall on an ever diminishing group of customers who rely on the public switch network for their telecommunications needs. (TR. Vol. 1, p. 15, line 4 - p. 16, line 18).

The Commission finds that even though the Company was under no requirement to prove the existence of competition in its market or the impact of competition on its operations, the Company has supplied sufficient evidence in that regard through the testimony and exhibits sponsored by witness Sokol. The Commission, then, finds that United may avail itself of incentive regulation for its intrastate operations under the guidelines, requirements and restrictions set forth herein and as set forth in the previous Orders of the Commission as may be amended from time to time. If United does not desire to comply with the requirements enunciated herein, then the Company shall be subject to the traditional rate of return regulation.

III.

APPROPRIATE TEST YEAR

For purposes of this proceeding, the Company proposed that its records and performance during calendar year 1991, adjusted for known and measurable changes, be utilized. Those changes, when properly made, adjust 1991 per book figures for known and measurable changes, a methodology embraced by our Supreme Court. Southern Bell Telephone & Telegraph Company v. Public Service Commission, 270 S.C. 590, 244 S.E.2d 278, 284 (1978). Therein, the Court stated:

> ...the Commission should make any adjustments for known and measurable changes in expenses, revenues and investments occurring after the test year, in order that the resulting rates will reflect the actual rate base, net operating income, and cost of capital. Support for this conclusion is found in the case of Mountain States Telephone & Telegraph Co. v. Public Utilities Committee, 182 Colo. 269, 513 P.2d 721, 724-725 (1973), wherein it was stated:
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> "The relationship between costs, investment, and revenue in the historic test year is generally a constant and reliable factor upon which a regulatory agency can make calculations which formulate the basis for fair and reasonable rates to be charged. These calculations obviously must take into consideration in-period adjustments which involve known changes occurring during the test period which affect the relationship factor. Out-of-period adjustments must be also utilized for the same purpose. An out-of-period adjustment involves a change which has occurred or will occur, or is expected to occur after the close of the test year.... Wages and salary increases which have been contracted for and which will take effect after the test year must also be analyzed in the process of calculations....
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> We agree that a blind adherence in this rate case to the relationship between costs, revenue and average investment in the historic test period without weighing the factors involved with proper in-period and out of period adjustments would be erroneous."

Integral to the use of a test year, representing normal operating conditions to be anticipated in the future, is the necessity to make normalizing adjustments to the historic test year figures. Only those adjustments which have reasonable and definite characteristics and which tend to influence reflected operating experiences are made to give proper consideration to revenues, expenses and investments. Parker v. South Carolina Public Service Commission, et.al., 280 S.C. 310, 313 S.E.2d 290 (1984). Adjustments may be allowed for items occurring in the historic test year, but which will not recur in the future; or to give effect to items of an extraordinary nature by either normalizing or annualizing such items to reflect more accurately their annual impact; or to give effect to any other items which should have been included or excluded during the historic test year. The Commission finds the twelve months ending December 31, 1991, to be the reasonable period for which to make our determinations herein.

IV.

ACCOUNTING AND PRO FORMA ADJUSTMENTS

A. Revenue and Expense Items

The Company, the Staff and the Consumer Advocate proposed certain adjustments to the Company's revenues, expenses, and rate base. Consistent with the Commission's finding concerning the need to make appropriate accounting and pro forma adjustments to establish the proper earnings level for the Company to begin incentive regulation, the Commission will consider the appropriate adjustments made by the parties. The Commission hereby accepts all adjustments agreed to by all parties. Consequently, the Commission will specifically address only those adjustments where the parties did not reach a consensus.[3]

Interest on Customer Deposits.

The Staff proposed to annualize interest on customer deposits. Consequently, the Staff increased the Company's expenses by $1,986 and, similarly, reduced its rate base by the same amount. The Commission finds that it is consistent with previous Commission practices to annualize interest on customer deposits and, further, that the Company's rate base should be reduced by $1,986 to reflect ratepayer-supplied funds.

Audit Fees.

During its examination of billings from United Telecommunications, Inc. (UTI)[4] to the Company, the Staff noted that the Company's audit fee accruals included five (5) months of the 1990 budgeted audit fees. The actual audit fees applicable to the test period were $5,802 lower than the 1990 budgeted fee. Therefore, the Staff reduced the audit fees based on agreed upon fees for the 1991 test year. The Commission finds this adjustment proper and, consequently reduces the Company's corporate operations expenses by $5,802.

3. During the hearing, Company witness Geller testified that United agreed with all the Staff's proposed adjustments, except for the one relating to the International Brotherhood of Electrical Workers (IBEW) contract. (TR. Vol. 1, p. 141, line 21 - p. 142, line 22). In its post-hearing brief, the Consumer Advocate stated it accepted the Staff's recommendations regarding lobbying expenses, legal fees, increases in officers' salaries, and miscellaneous expense adjustments. Consumer Advocate's Brief, p. 15.

4. United is a wholly-owned subsidiary of Sprint Corporation.

Lobbying Expenses.

The Staff proposed to remove $11,021 from the Company's corporate operations expense and $2,867 from plant specific expense for lobbying. The Staff reviewed the Company's expense reports for United's South Carolina Director of Governmental and Regulatory Affairs and eliminated $1,760 in expenses which were not incurred for the primary benefit of providing telecommunications service. The Staff proposed to remove $2,867 from the Company's rent expense for this employee by using the same percentage of his total non-allowable expenses as derived from his time study.

The Staff also reviewed UTI's allocation of lobbying expenses to United for its Washington, D.C. office. The Staff determined that 50% of this allocation or $9,261 should be disallowed because approximately 50% of the functions of this office were for non-regulated or lobbying purposes. The adjustment for $9,261 is included within the above referenced reduction to corporate operations expense.

The Commission finds that, in keeping with its tradition of not allowing recovery of certain lobbying expenses, the Staff's adjustments are appropriate. Further, the Commission notes that all parties have agreed to the Staff's treatment of lobbying expenses.

Community Projects and Wellness Program.

The Staff proposed to lower expenses allocated from UTI to United relating to community projects and the Company's wellness program. The Staff determined that eight (8) of the ten (10) functions performed by the community projects department were charitable, civic, or image-building in nature. Therefore, the Staff proposed to remove 80% of this expense. In addition, the Staff reviewed a description of the Company's wellness program and determined those allocated expenses should be disallowed since the primary costs were associated with operating employee fitness facilities.

The Commission finds that 80% of the Company's community project expenses should be disallowed because charitable, civic, and image-building programs are not appropriate ratepayer expenses. Further, the Commission concludes that expenses associated with the Company's wellness program should also be disallowed because United's South Carolina ratepayers receive no benefit from the program.

Legal Fees.

The Company incurred legal fees of $84,330 during the test year. These expenses included legal fees from the Company's last rate case (See Order No. 91-362, Docket No. 89-299-C, May 28, 1991), a wrongful termination suit brought by its former employees, and other related legal expenses. The Staff proposed to amortize the Company's expenses related to the lawsuit over five (5) years including amounts spent in 1992 for copies. Further, the Staff proposed to amortize the remaining legal expenses which the Company had included, but not yet fully recovered, from its last rate case. Finally, the Staff proposed to disallow all legal fees associated with non-regulated services.

The Commission concludes that the Staff's proposed handling of these expenses is consistent with the Commission's historic treatment of legal expenses. In addition, the Commission finds the Company's 1992 expenses to be known and measurable and, therefore, properly included in the Company's expenses. Consequently, the Commission approves the Staff's adjustment.

Rate Case Expenses.

The Staff proposed to amortize the Company's last rate case expenses in Docket No. 89-229-C over three (3) years. The Staff included those costs incurred in 1992 concerning this docket in its amortization.

The Commission concludes the Staff's adjustment is appropriate. The Commission has consistently allowed the recovery of rate case expenses over a three (3) year period. Further, the Commission finds those rate case expenses incurred outside of the test year to be known and measurable and, therefore, recoverable.

"Non-Allowable" Items.

The Staff proposed to remove contributions, certain meals and entertainment expenses, advertising, employee gifts, awards, parties and club dues, sponsorships of sports teams and events, novelty and image building items, employee newsletter costs, membership in social and athletic clubs, and a portion of the Company's dues paid to the United States Telephone Association (USTA) and the South Carolina Telephone Association (SCTA) from the Company's expenses. The Staff noted that the Commission has disallowed the recovery of these expenses because they are not necessary to the provision of telephone service.

The Commission finds that these expenses are unnecessary for the provision of telephone service. Therefore, the Commission approves the Staff's adjustment.

Expenses Associated with Economic Development.

The Staff eliminated $930 of expenses for employee meals, entertainment, travel, and lodging associated with economic development. The Staff noted that the Commission has not ruled previously on the appropriate accounting treatment for costs associated with economic development.

At the hearing the Company did not take issue with the Staff's adjustment regarding expenses for economic development. (TR. Vol. 1, p. 141, lines 18 - p. 142, line 2.) Therefore, the Commission approves the Staff's adjustment.

Revenues and Expenses Associated with E-911.

By contract, United is to provide the County of Greenwood with Emergency 911 (E-911) service at some future date. During the test period the County paid United $14,145 in non-recurring installation charges associated with the E-911 system. During the test year, the Company expensed $8,411 due to work involving the E-911 system. The $14,145 was booked as revenue and the $8,411 was booked as expenses by the Company during the test year.

Additionally, as of the end of the test period, the County of Greenwood had paid United $67,191 for equipment needed to operate the E-911 system. The $67,191 has accumulated into Account 4360, Other Deferred Charges and Credits, on the books of the Company since the inception of the E-911 project which was approximately eighteen (18) months old as of the end of the test period. The Company proposed to treat the $67,191 contained in Account 4360 as deferred revenue.

During the Staff's audit, the Company informed the Staff that the contract may be subject to renegotiation. Consequently, because the effects of the E-911 service are unknown and not measurable at this time, the Staff proposed to eliminate the effects of E-911 for purposes of this proceeding and to treat the $67,191 as a contribution in aid of construction.

The Commission finds that the revenues and expenses associated with E-911 service to the County of Greenwood are non-recurring and should be eliminated for purposes of this proceeding. The Commission concludes that since the deferred revenues of $67,191 are associated with E-911 equipment and the final disposition of such equipment has not yet been determined, it is proper to treat these deferred revenues as a contribution in aid of construction.[5]

Interest Synchronization.

Staff proposed to record the effects of interest synchronization on income taxes. The Staff proposed to increase operating taxes by $17,284. The Company proposed an adjustment to its per book figures in the amount of $2,558. The Consumer Advocate proposed an interest synchronization adjustment of $17,000. The differentials between the three recommendations are attributable to different rate base adjustments, cost of debt

5. The Commission recognizes that this adjustment reduces United's rate base by $67,191.

components, and capital structure. Based on the Commission's determinations herein, the Staff's adjustments are appropriate and are adopted in this proceeding.

Employee Income Protection Plan.

The Company, the Consumer Advocate, and the Staff proposed to amortize the expenses associated with United's employee income protection plan (EIPP) over the period in which the benefits will be paid to the employee. The Staff's adjustment includes a reduction in payroll taxes applicable to such benefits.

The Commission accepts the Staff's adjustment. The Commission finds it appropriate to expense the EIPP liability over the payment period to the employees who took advantage of the program.

Interest During Construction.

Both the Staff, the Consumer Advocate, and the Company propose to reflect interest during construction (IDC) on an end of period level. The Staff's adjustment includes IDC on a short term project which was reclassified as a long term project after the end of the test year. The Commission finds that the Staff's adjustment is appropriate for this proceeding and, therefore, adopts the adjustment.

Wages, Salaries, and Officer Incentive Compensation Payments.

The Staff proposed to annualize wage increases which took place during the test year based on end of year employee levels. The Staff's adjustment does not reflect lump sum payments to employees, excludes increases for EIPP participants and corrects an erroneous crossbilling percentage for the Company's marketing department. The Staff included the effect on payroll taxes within its adjustment.

The Commission finds it appropriate to annualize for all known and measurable wage/salary changes which occurred during the test year. Further, the Commission finds it appropriate to remove increases for EIPP participants and lump sum payments during the test year as these expenses are not recurring.

The Company proposed to annualize wage increases which took place and which were scheduled to take place after the end of the test year. The Staff proposed to include pay increases after the end of the test year only if covered by a current union contract and only utilizing test year ending employee levels.

The Consumer Advocate proposed that any wage increases occurring after the test year be disallowed. The Consumer Advocate argued that wage annualization to recognize a salary increase after the end of the test year violates the test year concept and results in a mismatching of revenues and expenses. The Consumer Advocate states that it is inappropriate to randomly annualize certain items for known and measurable costs beyond the test year and not annualize other revenues and expenses. The Consumer Advocate contends that if it accepts the Company's adjustment, the Commission should extend the customer growth adjustment through the latest known period for which information is available and recognize the Company's projected reduction to pension expense for 1992.

As of the hearing, United witness Thomas Geller testified the

Company's labor negotiator and the union president of the International Brotherhood of Electrical Workers (IBEW) had signed an agreement as to the terms of the parties' new contract. Testimony at the hearing indicated that the IBEW union workers were scheduled to vote on the contract on November 9, 1992. The Company agreed to provide the Commission with the results of the vote and a copy of the signed contract. The Commission has received a copy of the November 1992 contract between United and the IBEW. This contract reflects salary increases for the IBEW members.

The Commission hereby approves the Company's annualization of its after-the-test-year wage increases, including those made by the IBEW contract. The South Carolina Supreme Court has previously held that the Commission should make adjustments for known and measurable expenses occurring after the test year in order that the resulting rates accurately reflect the financial situation of the utility. Southern Bell v. Public Service Commission, supra. The Commission concludes that the United and IBEW union agreement was finalized prior to the issuance of the Commission's decision on this matter and that the increased wages were known and measurable. Therefore, the Commission concludes that these increased wages should be accepted and annualized for the end of test year employees.

The Commission finds, however, that it would be inappropriate to adjust customer growth and the Company's pension expense as recommended by the Consumer Advocate. As noted by Hearing Exhibit 4, United's response to the Consumer Advocate's First Set of

Interrogatories, Question 1-29, the Company's 1992 expected pension expense is merely projected. Consequently, unlike the annualization adjustment made for a given salary increase for a known number of employees at the end of the test year, the Company's projected pension expense is not known and measurable. Therefore, the Commission concludes it would be improper to adjust the Company's test year pension expense to reflect its anticipated 1992 pension expense.

Further, the Commission finds and concludes that by annualizing the Company's known 1992 salary increases to its end of test period employees and not adjusting the Company's after test year customers, there is no mismatch of revenues and expenses. The Commission has not altered the number of employees from those at the end of the test year. Consequently, the Commission finds it would be inappropriate to alter the number of customers from the end of the test year.

The Staff proposed to reduce salaries, wages and related taxes for United's officer pay increases included in the test year expenses. In addition, the Staff removed officer incentive compensation payments from the Company's test year expenses.

The Commission adopts the Staff's proposed adjustments. As noted by both the Staff and Consumer Advocate witness Philip Miller, it has been the Commission's policy in previous United proceedings, as well as in other major utility proceedings, that officer salary increases not be included in test year operating expenses. Instead, the Commission has held that test year increases in officers' salaries are expenses which should be borne by the utility's stockholders rather than its ratepayers. For the same reason, the Commission concludes that officer incentive compensation payments should not be recovered from ratepayers. Further, officer incentive compensation payments may not be recurring expenses of the Company and, therefore, should be disallowed.

Equal Access Costs.

The Staff proposed to amortize the Company's cost of providing equal access over ten (10) years. This proposal reduces the Company's customer operations expenses by $14,432. The Staff's adjustment includes the unamortized costs of equal access in rate base in order to have a more revenue neutral effect.

The Commission finds that the Staff's proposal is consistent with prior rulings of this Commission. Therefore, the Commission adopts the Staff's adjustments.

Customer Surveys and Asbestos Respiratory Protection Program.

The Staff proposed to remove out of period costs for customer surveys, thereby reducing the Company's customer operations expenses by $799. Additionally, the Staff proposed a five year amortization of the Company's asbestos respiratory protection program. This proposal reduces the Company's corporate operations expenses by $389. The Commission finds that no parties have expressed any objection to these adjustments and, therefore, concludes that both of these adjustments are appropriate for ratemaking purposes.

Toll Pool Revenues.

The Staff proposed to adjust the Company's operating revenues to reflect the effect on its toll pool settlements with other local exchange companies because of pro forma and accounting adjustments made to United's rate base and operating expenses. The Company recognized the toll pool effects associated with expenses only.

The Commission recognizes that all long distance toll revenues collected for intraLATA calls are placed in a pool and that each local exchange company is allocated a portion of the revenue from the pool. After considering the proper adjustments to the Company's rate base and operating expenses, the Commission concludes that the Staff's adjustments are appropriate.

Post Retirement Benefits Other than Pensions.

During the test year, United booked its expenses for its retirees' post retirement benefits other than pensions (OPEBs) using the "pay-as-you-go" (cash) basis of accounting. The Company proposed to adjust its expenses to include the effect of adopting the Statement of the Financial Accounting Standards (SFAS) No. 106. SFAS No. 106 requires companies such as United to account for OPEBs, such as health benefits, on an accrual basis. Accounting on an accrual basis treats the OPEBs as a current operating expense. Under SFAS No. 106, accrual basis accounting is required to begin no later than January 1, 1993.

According to Company witness Geller, the accrual method required by SFAS No. 106 is more appropriate than the current pay-as-you-go basis. Mr. Geller explained:

> The objective of accrual accounting is to record the financial effects of transactions in the periods in which they occur, to the extent that these effects are recognizable and measurable. SFAS No. 106 concludes that OPEBs are a form of deferred compensation similar to pensions. The accrual method of accounting recognizes the cost of postretirement benefits compensation during the period in which employees perform services to earn their benefits, even though the benefits may not be paid until sometime in the future. The cash method delays the cost of OPEBs until the employees are retired and no longer providing value to the Company and its customers, resulting in unrecorded liabilities and misallocation of costs during the employees' service lives and retirement.
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> From a financial accounting standpoint, it is necessary to match the recognition of the costs of OPEBs with the earning of these benefits by employees. Likewise, from a ratemaking perspective, it is preferable to recover OPEB costs during the years that the employees serve and benefit our customers. Otherwise, future customers will be charged OPEB costs that relate to services provided to customers in the past. (TR. Vol. 1, p. 134, line 4 - p. 135, line 4.)

Mr. Geller noted that the Federal Communications Commission (FCC) has directed telephone companies to adopt SFAS No. 106 for regulatory accounting purposes and to amortize the transition obligation. Mr. Geller testified that United has determined to amortize the SFAS No. 106 transition obligation over the maximum period allowed, twenty years, in order to minimize the impact on company earnings and rates charged to its ratepayers from adopting the accrual method under SFAS No. 106.

Mr. Geller further testified that the adoption of SFAS No. 106 does not actually increase United's expenses but, instead, changes the timing of the expenses. Mr. Geller explained that, instead of deferring OPEB expenses until some period in the future, the

Company will recognize a portion of the expense each year.

The Staff agreed with United's adjustment to reflect the effect of SFAS No. 106. However, in determining the cost of benefits for United's current employees, the Staff recommended to use actuarial valuations through the year 1992, instead of valuations through the year 1993, as proposed by United. The Company has since agreed to this valuation. See United, Brief, p. 16.

The Consumer Advocate opposed the Company's adjustment, and instead, recommended that United continue using the pay-as-you-go method for ratemaking purposes. Consumer Advocate witness Miller testified that the proposed accounting change increases the intergenerational inequities between customers because it causes current customers to bear the cost of serving more than one generation of customers in their rates. Mr. Miller explained that, while "current customers should be expected to pay the expected postretirement benefit obligation attributed to the employee service during the current period" (TR. Vol. 2, p. 134, lines 3-5), the current customer should not also be required to pay the accumulated postretirement benefits of employees who provided service in prior years. Mr. Miller testified that, although current customers are paying the postretirement expenses of those employees who did not serve them under the pay-as-you-go method, they are, however, only paying for one generation of employee-retirees.

Mr. Miller further testified that "the accrual method required by SFAS No. 106 is not as reflective of the current service costs as the calculation based upon the pay-as-you-go method and that it is not as appropriate for ratemaking purposes." TR. Vol. 2, p. 33, lines 9-11. Mr. Miller explained that, because the actual costs of future OPEBs is unknown, the expense does not meet the known and measurable standard for ratemaking. In addition, he testified that the future OPEB liability may change if United's postretirement benefits are modified. Finally, Mr. Miller testified that, because a higher liability translates into higher rates, regulated entities such as United have an incentive to select a larger rather than smaller estimate of OPEB cost.

Mr. Miller testified that if the Commission rejects the Company's request to adopt the accrual method for ratemaking purposes United will not run afoul of generally accepted accounting principles (GAAP). Mr. Miller stated that GAAP will not be violated if the Commission allows United to recognize the difference between the pay-as-you-go and accrual methods as a regulatory asset pursuant to SFAS No. 71. Mr. Miller admitted that the Commission would need to allow United to recover this difference, the regulatory asset, in future revenues. Mr. Geller testified, however, that treating the difference between the accrual and pay-as-you-go methods as a regulatory asset will have a greater negative impact on the Company's ratepayers as opposed to adopting SFAS No. 106 for ratemaking purposes.

The Commission has carefully reviewed the Consumer Advocate's arguments regarding the appropriate method of accounting for OPEB's and finds the arguments unpersuasive. The Commission notes that, regardless of the accounting method employed, United is liable for the OPEBs of its employees. However, the Commission finds that the accrual method of SFAS No. 106 recognizes the true OPEB expense that United actually incurs for its current employees and appropriately matches this expense to the appropriate accounting period. Further, the Commission finds and concludes that the accrual method directly matches the cost of service rendered by United's employees with those ratepayers to whom the service is provided. Moreover, any intergenerational inequity associated with the transition from the pay-as-you-go method to the accrual method is only temporary.

Further, the Commission finds that the cost for OPEBs associated with United's current employees meets the known and measurable standard for ratemaking. United's OPEB liability is computed by an actuarial valuation which is updated each year to reflect any changes in the Company's postretirement benefit plans or in economic conditions. Consequently, the actuarial valuation is self-correcting. Finally, the Commission notes that no party has challenged the calculation of the Company's pension expense which is also determined by an actuarial study.

Moreover, the Commission finds no merit to the Consumer Advocate's argument that under the accrual method United has an incentive to overstate its OPEB liability. There is absolutely no evidence in the record from this proceeding that United has overestimated its expenses. Further, should it ever be determined that United has overstated any expense, the Commission can and will disallow the expense as imprudent.

Finally, the Commission concludes that, in recommending that United continue to employ the pay-as-you-go method for ratemaking purposes, the Consumer Advocate has ignored the necessity and effect of establishing a regulatory asset. As admitted by witness Miller on cross-examination, if this Commission requires United to continue to account for its OPEB liability using the pay-as-you-go method, the Commission will be required to set up the cost difference between the accrual and pay-as-you-go methods as a regulatory asset and allow United to recover this difference in future rates. As stated by witness Geller, United's ratepayers will incur a greater expense if required to support the pay-as-you-go method, composed of the regulatory asset and the OPEB liability of prior retired employees, than if required to support the accrual method, composed of the transition costs for prior retirees and the accrued liability for current employees.

For each of the above reasons, the Commission finds that the Company's proposal to adjust its books to reflect the accrual method of accounting for OPEBs is appropriate for ratemaking purposes. However, the Commission adopts the actuarial valuation through 1992 as recommended by the Staff.[6]

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6. The rate base effect of adopting the accrual method of accounting for OPEBs includes recognizing the capitalized benefits as an asset and reducing rate base for the unfunded liability.

NECA Payment.

Shortly before the hearing United was notified by the National Exchange Carrier Association (NECA) that it would be receiving $261,661 in payments from the Universal Service Fund. The Company proposed to include this in its test year revenues. No parties have objected to this accounting treatment of the payments, therefore, the Commission adopts the Company's proposal.

Customer Growth.

The Staff proposed to compute customer growth using an average based on beginning of year and end of year access lines. The growth factor was then applied to the Staff's net operating income. The Company developed its growth factor by using a thirteen (13) month average of access lines and then applied this factor to its net operating income. The Consumer Advocate utilized the same factor as developed by the Company.

The Commission approves the Staff's adjustment for customer growth. The Commission notes that the Staff's customer growth adjustment is based on a standard formula approach which it has typically approved in past proceedings. Customer growth shall be adjusted using the Staff's methodology and the approved net operating income stated by this Order.

Amortization of Excess Accumulated Deferred Income Taxes.

According to Consumer Advocate witness Miller,

> The Tax Reform Act of 1986 (TRA 86) decreased the corporate tax rate from 46% to 34%. As a result, utilities which had been making additions to their reserves for deferred taxes at the 46% rate had an "excess" in their reserves for deferred taxes. The reason for this is that federal income tax deferrals

> which had been computed based upon a tax rate of 46% will be "reversed" out when the tax rate is only 34%. This same situation occurred in 1978 when the corporate tax rate was lowered from 48% to 46%. (TR., Vol. 2, p. 158, lines 3-9).

Because of these changes in the income tax rates and the timing differences between when an item is recognized for book and tax purposes, excess accumulated deferred income taxes are created on the Company's books. The Consumer Advocate recommended that certain "credit balances" in United's accumulated deferred income tax account be flowed back to the ratepayers over an accelerated period of two (2) years.[7]

The Commission has reviewed the Consumer Advocate's recommendation and finds it unpersuasive. The evidence of record on this matter indicates that the Consumer Advocate singled out the excess accumulated deferred income tax credit balances relating to the Company's Unicap and Pensions and ignored the excess accumulated deferred income tax debit balances pertaining to Disallowed ADR and RAR (481a). See Hearing Exhibit 4. These debit balances more than offset the credit balances for Unicap and Pensions. The Commission notes that if it were to apply the Consumer Advocate's recommendations in a consistent manner, the Company's income tax expense would be increased. Consequently, the Commission concludes it is inappropriate to adopt the Consumer Advocate's recommendation for a two year amortization of excess

7. Typically, the Commission has flowed back any net unprotected excess credit in the accumulated deferred income tax account over five (5) years.

unprotected accumulated deferred income taxes.

B. Rate Base Items

Pursuant to S.C. Code Ann., §58-9-570 (1976), in ratemaking proceedings involving a telephone utility, the Commission must "give due consideration to the telephone utility's property devoted to the public service...". This consideration is traditionally made in the context of the determination of the utility's rate base.

For ratemaking purposes, the rate base represents the total net value of the telephone utility's tangible and intangible capital or property value on which the telephone utility is entitled to earn a fair and reasonable rate of return. Generally, the rate base, as allocated to the Company's South Carolina intrastate operations, is composed of the value of the Company's property used and useful in providing telephone service to the public, plus construction work in progress, materials and supplies, an allowance for cash working capital, and property held for future use. The rate base computation incorporates reductions for the reserve for depreciation and amortization (accumulated depreciation), accumulated deferred income tax, contributions in aid of construction and customer deposits. The Accounting Department of the Commission Staff, prior to the date of the hearing, conducted an audit and examination of the Company's General Ledger, including rate base items, with plant additions and retirements.

In the instant proceeding, the Commission Staff conducted an analysis of the items and amounts which the Company proposed to be included in its intrastate rate base for ratemaking purposes. On the basis of the Staff's audit, the exhibits, and the testimony of all parties contained in the evidentiary record of the proceeding, the Commission can determine and find proper balances for the components of the Company's rate base, as well as the propriety of related accounting adjustments.

This Commission is among the majority of regulatory agencies which provide for the determination of a utility's rate base on an end of test year basis, a result which most reasonably coincides with the prospective operation of any ratemaking action. The use of a "year end" rate base likewise serves to enhance the timeliness of the effect of such action and preserves the reliance on historic and verifiable accounts without resort to speculative or projected figures. Consequently, the Commission finds it most reasonable to retain its consistent regulatory practice herein and evaluate the issues in this proceeding founded on a rate base for the Company's intrastate operations as of December 31, 1991.

Annualization of Depreciation Expense.

The Company proposed to record the rate base effect of annualizing its depreciation expense. The Company's proposal had the effect of decreasing its depreciation expense, thereby increasing its rate base. During its audit, the Staff noted that Account 2321, Customer Premise Wiring, had no plant balance and no accumulated depreciation balance. The Company and the Staff proposed to lower depreciation expense by $283,578 for this account causing the depreciation adjustment to become a negative amount. The Staff proposed that, since there was no accumulated balance in this account, it would be improper to adjust accumulated depreciation. The Commission recognizes that the Company now agrees with the Staff's proposal and that the Consumer Advocate has expressed no opinion regarding this issue. Consequently, the Commission approves the Staff's proposal.

Annualized Interest on Customers' Deposits.

The Staff proposed to record the rate base effect of annualizing interest on customers' deposits. The Company ultimately agreed with this adjustment; the Consumer Advocate expressed no opinion on this adjustment. The Commission finds the Staff's adjustment appropriate for ratemaking purposes and approves the adjustment.

Plant Held for Future Use.

The Staff proposed to reduce the Company's rate base by $297 for telephone plant held for future use. This plant has been on the Company's books in excess of the two (2) year period specified by the chart of accounts. The Company agreed with this adjustment; the Consumer Advocate expressed no opinion on this adjustment. The Commission finds the Staff's adjustment appropriate for ratemaking purposes and approves the adjustment.

Unclaimed Funds.

The Staff proposed to reduce United's rate base by $696 for unclaimed funds found on the Company's books during its audit. The Commission finds that the Company should not be allowed to earn a return on unclaimed funds and, therefore, approves the Staff's adjustment.

Directory Operations.

In Order No. 91-362, the Commission stated that in all future ratemaking proceedings regarding United, "100% of the revenues of a subsidiary/affiliate directory [publisher] shall be imputed to the operating revenues...". Order, p. 29. Consequently, in this proceeding the Company adjusted its books to include the revenues and expenses of its publishing company in its own revenues and expenses. Similarly, United adjusted its rate base to include its investment in directory operations. This adjustment increased the Company's cash working capital by $679,085, primarily for prepaid expenses. The Staff concurred with the Company's adjustment. The Consumer Advocate disagreed with the Company's proposal to include the working capital of United's directory affiliate in the Company's rate base.

The Commission finds that if United is required to fully impute all of the revenues of its directory affiliate, it should likewise be permitted to recognize the capital invested in fixed assets and prepaid expenses which are used in order to operate the publishing business. Thus, the Commission concludes that the cash working capital of the Company's directory affiliate is a proper rate base item on which the investor is entitled to earn a return. Accordingly, the Consumer Advocate's recommendation is denied.

Cash Working Capital.

Consumer Advocate witness Miller explained the concept of working capital:

> In addition to a utility's investment in plant in-service that is used to render utility service, there is also an investment required to support day-to-day operations. This investment results because either payments for goods and services are made prior to the collection of the revenues for the goods and services provided (positive working capital), or the revenues associated with the goods and services are collected before the associated payments are made (negative working capital). This investment is known as cash working capital. Additionally, utilities have other investments in addition to the plant investment. For example, materials and supplies is an element of working capital. (TR., Vol. 2, p. 151, lines 2-12).

Mr. Miller explained that "[t]here are three generally accepted methods for determining the proper cash working capital allowance which should be included in rate base." (TR., Vol. 2, p. 152, lines 1-2). Mr. Miller described these three methods: lead-lag study, balance sheet analysis of non-plant investments less non-investor sources of funds, and formula method. Mr. Miller testified that the Consumer Advocate preferred the use of a lead-lag study because it "is normally regarded as the most accurate method of determining the cash working capital requirements." (TR., Vol. 2, p. 152, lines 17-18). Because the Company did not prepare a lead-lag study, Mr. Miller recommended that the cash working capital allowance be set at zero. This recommendation reduces the Company's rate base by $865,797.

The Company proposed that its cash working capital allowance be set using the 20-day formula allowance previously approved by the Commission in other proceedings. This 20-day allowance recognzies the delay between the Company's provision of telephone service, and the service's corresponding expense, and the Company's receipt of revenues from its customers.

The Staff agreed with the Company's proposal. Staff witness Ellison testified that a lead-lag study is open to subjective interpretation and manipulation and that there was no reason why use of a lead-lag study is preferable to the formula method for determining the appropriate cash working capital allowance.

The Commission concludes that use of the 20-day allowance to establish the Company's cash working capital is preferrable in this proceeding. Based on the testimony from the hearing, the Commission finds that a lead-lag study is subject to interpretation and manipulation and, consequently, the Commission concludes that its 20-day cash working capital allowance is appropriate.

Miscellaneous Adjustments.

All other adjustments proposed by Staff and not objected to by any party are hereby adopted. All other adjustments proposed by the various parties not specifically addressed herein have been considered by this Commission and have been denied. General taxes, State income taxes, and Federal income taxes will be adjusted to reflect all adjustments approved herein by the Commission.

Based on the approved adjustments as noted above, it is the opinion of the Commission that the South Carolina intrastate rate base at December 31, 1991, of $50,131,691 is both reasonable and appropriate. That rate base is shown in the following table:

TABLE A

ORIGINAL COST RATE BASE

SOUTH CAROLINA INTRASTATE OPERATIONS

DECEMBER 31, 1991

	$
Telephone Plant in Service	109,270,304
Accumulated Depreciation	(53,491,066)
Net Plant in Service	55,779,238
Telecommunications Plant Under Construction	784,143
Property Held for Future Use	-0-
Materials and Supplies	254,185
Cash Working Capital	752,136
Contributions in Aid of Construction	(376,393)
Accumulated Deferred Income Taxes	(6,218,440)
Customers' Deposits	(843,178)
Total Rate Base	50,131,691

After establishing the appropriate rate base, it is the Commission's obligation to apply the Company's total operating income for return to the Company's rate base to determine what adjustments, if any, to the present rate structure are necessary to generate earnings sufficient to produce a fair rate of return to meet the needs of the utility. In Bluefield Water Works and Improvement Co. v. West Virginia Public Service Commission, 262 U.S. 679, 692, 43 S.Ct. 675 (1923), the Court stated the applicable constitutional standard as follows:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under

> efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties....

This standard was reaffirmed by the Court in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 64 S.Ct. 281 (1944), where the Court stated:

> ...the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital...

In the Permian Basin Area Rate Cases, 390 U.S. 474, 492, 88 S.Ct. 1344, 1373, 20 L.Ed.2d 312 (1968), the Court added that the results of a rate order must "fairly compensate investors for the risks they have assumed...." This Commission has acknowledged these standards and has applied them in numerous cases in the past.

It is clear from these cases that the capital structure selected by the Commission in this proceeding must be one which accurately reflects the business and financial risks presented by the utility which is the subject of regulation. Otherwise, the constitutional tests of reasonableness for a rate of return cannot be met. Moreover, the Commission is cognizant of its obligation pursuant to S.C. Code Ann. §58-9-570 (1976) to give "due consideration to...the capitalization of the telephone utility...."

The Commission finds that the applicable legal principles and the substantial evidence of record require that the consolidated capital structure of United Telephone System be adopted for use in this case. This finding is consistent with the capital structure utilized by each of the cost of capital witnesses. The specific capital structure which the Commission adopts for use in this proceeding is depicted in the following table:

TABLE B
CAPITALIZATION - PER BOOKS

June 30, 1992

	Amount (thousands) $	Ratio
Long-Term Debt	1,256,549	35.59%
Preferred Stock	13,794	.39
Common Equity	2,260,763	64.02
TOTAL	3,531,106	100.00%

Consumer Advocate witness Legler expressed concern over the proportion of common equity in the capital structure and suggested that capping the equity ratio at 60% may be appropriate. Dr. Legler recommended that the Commission review the reasonableness of the proposed capital structure in future cases if the equity ratio continues to increase. The Commission will review the reasonableness of the proposed capital structure in future cases.

The capitalization displayed in Table B reflects the actual consolidated capital structure of United Telephone System as of June 30, 1992, which the Commission finds fair and reasonable for ratemaking purposes in this proceeding. The capitalization and associated ratios have been utilized in the determination of a fair rate of return for the Company's operations.

In regard to the issue of cost of capital, the record indicates that, as of June 30, 1992, the embedded cost of long-term debt for the United Telephone System was 8.90%. The record also indicates that as of June 30, 1992, the embedded cost of preferred stock for the United Telephone System was 6.79%. The capital structure and embedded cost data for June 30, 1992, is the most recent Commission Staff audited data available. Accordingly, the Commission concludes that the embedded cost of long-term debt of 8.90% and the embedded cost of preferred stock of 6.79% should be used in its determination of the cost of capital.

One of the principal issues in any ratemaking determination involves the proper earnings to be allowed on the common equity investment of the regulated utility. In this proceeding, the Commission was offered the expert testimony of three witnesses relating to the fair and reasonable rate of return on common equity for the Company. These financial experts presented detailed explanations of a number of methodological approaches to the determination of the cost of equity capital.

The Commission's analysis of the evidence regarding the appropriate return on equity in this case must be guided by the constitutional principles set forth by the Supreme Court of the United States in Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, supra, and Federal Power Commission v. Hope Natural Gas Company, supra. These tests can be summarized as follows:

1. The allowed return on common equity should be the same as that earned on other investments of comparable risk.

2. Utilities have no constitutional right to profits realized by more speculative ventures.

3. The allowed return should be sufficient to maintain the utility's credit standing and enable it to raise necessary capital.

4. A reasonable return may vary over time reflecting changing economic conditions.

While the Commission adheres to no particular theory or methodology for the determination of a fair rate of return on common equity, it does test the various recommendations before it against these constitutional standards to determine the reasonableness of the approaches proposed by the various parties. With these legal standards in mind, the Commission is able to fulfill its function of engaging in a careful analysis of the abstract theories before it for application in a practical context.

The Commission must appraise the opinions of the expert financial witnesses as to the expectations of investors and the opportunity costs of equity capital in conjunction with the tangible facts of the entire record of the proceeding, including the observable financial conditions of the Company. In its determination of a fair and reasonable rate of return, the Commission maintains the ultimate responsibility of setting the rates to be charged for the telephone services provided by the Company in South Carolina. The exercise of that responsibility involves the balancing of the interests of the subscriber and of the investor.

The cost of equity analyses performed by each witness were very similar. In particular, each witness utilized a Discounted

Cash Flow (DCF) method and the Capital Asset Pricing Model (CAPM) and applied each method to at least one comparison group of telecommunications companies.

Company witness, Mr. John D. Quackenbush, recommended a 13.75% rate of return on common equity. His DCF analysis produced returns on equity for industrial companies in his comparison group ranging from a low of 11.64% to a high of 14.10%. The average return for his comparison group was 12.51%. His CAPM analysis produced a return on common equity for his comparison group of 14.71%. Witness Quackenbush included a stock issuance cost adjustment of 24 basis points in his recommendation.

Consumer Advocate witness, Dr. John B. Legler, recommended a return on common equity of 11.75%. Dr. Legler's DCF analysis produced returns on equity for his comparison group companies ranging from a low of 7.41% to a high of 16.40%. The average return for his comparison group ranged between 9.89% and 12.10%. His CAPM analysis produced returns on equity between 11.99% and 13.23%. Witness Legler did not include a stock issuance cost adjustment in his recommendation.

Staff witness, Dr. James E. Spearman, recommended a return on common equity in the range of 12.00% to 12.50%. His DCF analysis produced returns on equity for individual companies in his comparison group ranging from a low of 8.36% to a high of 16.64%. The average return for his comparison group ranged between 10.67% and 13.69%. His CAPM analysis produced average returns on equity in the range of 11.64% to 12.90%. Witness Spearman did not include a stock issuance adjustment in his recommendation.

After full consideration of the opinions of the expert witnesses and after balancing the interests of the Company and the investor, the Commission finds that a fair and reasonable rate of return on common equity for the Company's operations in South Carolina is 12.50%, which is within the recommended range of witness Spearman and within the computed ranges, although not the recommended ranges, of both witnesses Quackenbush and Legler. Because the Company has not recently issued nor does it intend to issue common stock in the near future, no stock issuance cost adjustment is necessary.

The ratemaking process requires a determination of the overall rate of return which the utility should be allowed the opportunity to earn. This Commission has utilized the following definition of "rate of return" in previous decisions, and continues to do so in this proceeding:

> For regulatory purposes, the rate of return is the amount of money earned by a regulated company, over and above operating costs, expressed as a percentage of the rate base. In other words, the rate of return includes interest on long-term debt, dividends on preferred stock, and earnings on common stock and surplus. As Garfield and Lovejoy have put it 'the return is that money earned from operations which is available for distribution among the various classes of contributors of money capital. In the case of common stockholders, part of their share may be retained as surplus.'
>
> Phillips, <u>The Economics of Regulation</u>, pp. 260-261 (1969).

The amount of dollars permitted to be earned by the Company through the operation of its rate structure depends upon the jurisdictional rate base and the allowed rate of return on the rate base. Although the determination of the return on common equity provides the necessary component from which the rate of return on rate base can be derived, the overall rate of return, too, as set by this Commission, must be fair and reasonable.

The United States Supreme Court, in the decision of Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, supra, delineated general guidelines for determining the fair rate of return in utility regulation. In the Bluefield decision, the Court stated:

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all the same general part of the country on investments in other business undertakings which are attended by corresponding risk to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequte under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business generally.
>
> 262 U.S. pp. 692-693.

During the following years, the Supreme Court refined those precepts, and, in the landmark Hope decision, the Court restated its views:

> We held in Federal Power Commission v. Natural Pipeline Gas Co....that the Commission was not bound to the use of any single formula or combination of formulae in determining its rates. Its ratemaking function, moveover involves the making of 'pragmatic adjustments' (cite omitted).... Under the statutory standard of 'just

and reasonable' it is the result reached, not the method employed which is controlling (cites omitted)....

The ratemaking process under the Act, i.e., the fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests. Thus we stated in the Natural Gas Pipeline Co. case, that regulation does not insure that the business shall produce net revenues. (cite omitted) But such consideration aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. (cite omitted). By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of that enterprise, so as to maintain its credit and to attract capital.

320 U.S. pp. 602-603.

The vitality of these decisions has not been eroded, as indicated by the language of the more recent decision of the Supreme Court in In Re: Permian Basin Area Rate Cases, supra. This Commission has consistently operated within the guidelines set forth in the Hope decision.

The rate of return which the Commission has herein found to be fair and reasonable should enable the Company to maintain and enhance its position in the capital markets. Patently, however, the Company must insure that its operating and maintenance expenses remain at the lowest level consistent with reliable service and exercise appropriate managerial efficiency in all phases of its operations.

The Commission has found that the capitalization ratios for consolidated United Telephone System as of June 30, 1992, are appropriate and should be used for ratemaking purposes in the instant proceeding. Likewise, the Commission has found that the embedded cost rates for long-term debt and for preferred stock of 8.90% and 6.79%, respectively, should be utilized in the determination of a fair overall rate of return. For the purpose of this proceeding, the Commission has found the proper cost rate for the Company's common equity capital to be 12.50%.

Using these findings, the overall fair rate of return on the Company's South Carolina intrastate rate base may be derived as computed in the following table:

TABLE C

OVERALL RATE OF RETURN

	RATIO	EMBEDDED COST/RETURN	OVERALL COST/RATE
Long-Term Debt	35.59%	8.90%	3.17%
Preferred Stock	0.39%	6.79%	0.03%
Common Equity	64.02%	12.50%	8.00%
TOTAL	100.00%		11.20%

V.

EARNINGS SHARING PLAN

Based upon the Commission's determination of an appropriate rate of return on equity for United and the Commission's earlier finding that United may avail itself of incentive regulation subject to the restrictions enunciated herein, the Commission must set the earnings parameters of the earnings sharing plan. In Order Nos. 90-849 and 90-1009, supra, the Commission set forth the requirements under the generic incentive regulation plan. Now that United has asked for incentive treatment, it must submit to the earnings parameters, guidelines, and requirements set forth herein. Otherwise, United will be afforded regulatory treatment under the traditional rate of return on rate base methodology.

Order No. 90-849 set out an earnings sharing plan that set a benchmark rate of return, a floor, a threshold, and a ceiling. This proceeding was for the purpose of establishing the benchmark. The Commission finds that based upon its finding that 12.50% return on equity is fair and reasonable, the benchmark rate of return will be appropriately set at 12.50%. This is consistent with the Commission's determination in Order No. 90-849 which found that the Commission would set the benchmark returns on return on equity or return on rate base, as appropriate. Since the Commission has traditionally regulated United using a return on equity approach, it is appropriate to set the benchmark return on a return on equity basis. Based on the further requirements of Order No. 90-849, the floor will be set at 11.50%, the threshold at 13.50% and the ceiling at 16.00%.

The plan approved by the Commission would establish a range of returns on equity as follows:

Ceiling..............................16.00%

50-50 Sharing

Threshold............................13.50%

Company Retains

Benchmark............................12.50%

Company Absorbs

Floor................................11.50%

Under the incentive plan, the Company may retain all earnings up to a threshold of 100 basis points above the benchmark return on equity. Thus, United may retain all earnings between the benchmark return of 12.50% and the threshold return of 13.50%. Earnings up to a ceiling of 250 basis points above the threshold will be shared equally (50/50) between the Company and the ratepayers. Therefore, United will share equally with the ratepayers any earnings between the 13.50% threshold return and the 16.00% ceiling return. All earnings in excess of the 16.00% ceiling return on equity will be refunded to the ratepayers. The Company may file for a rate increase only if its return on equity falls below a floor return of 100 basis points below the benchmark return. Thus, United may file for a rate increase only if its return on equity falls below 11.50%.

If earnings over the benchmark are not as a result of increased efficiencies or productivity, the Company is not entitled to keep those additional earnings. Witness Walsh put forth the options available to the Commission if, after the twelve month review, United's additional earnings are not because of increased efficiencies or productivity:

> If the Commission determines that United had not made a sufficient showing of improved or increased efficiencies or productivity, then the Commission could consider two courses of action. First, the Commission could require, under this proposal, that the Company refund to its ratepayers all earnings in excess of the approved benchmark, with interest. The rate of interest would be determined by the average treasury bill during the 12 month period under review. Second, the Commission could then have the ability, as provided in Order No. 90-1009, issued October 19, 1990, in Docket No. 90-266-C to take United out from under incentive regulation if improved efficiencies or productivity are not shown.
>
> (TR. Vol. 2, p. 178, line 17 - p. 179, line 6.)

In the event the Commission's twelve month review reveals that any additional earnings are not as a result of increased efficiencies or productivity, the Commission has determined that it will adopt the recommendations of witness Walsh, as outlined above. This is consistent with our intent of incentive regulation.

Having clarified how earnings should be distributed, it is encumbent upon the Commission to establish the guidelines necessary to review the earnings of United so that it may be determined whether or not any earnings above the benchmark are the result of the Company's increased efficiencies and productivity. The Commission Staff, through the testimony of witness Walsh, proposed certain efficiency guidelines. According to witness Walsh,

> [t]hese efficiency guidelines would provide the Commission with 12 months of data filed on an annual basis for specific revenue, expense and investment categories, as well as quality of service and financial information. Staff proposes at the end of the initial year under incentive regulation that the guideline data be filed comparing the 12 month period prior to

> incentive regulation with the 12 month period under incentive regulation. In subsequent years, Staff would recommend a comparison be filed for the 12 month period prior to incentive regulation and for each 12 month period under incentive regulation. These comparisons will enable the Commission to review these results concerning trends which have developed since the inception of incentive regulation.
>
> (TR., Vol. 2, p. 172, line 24 - p. 173, line 14.)

The guidelines proposed by Staff included (1) operating expenses on a cost per access line basis, (2) the ratio between plant specific expenses and the respective plant specific asset category, (3) the ratio between plant nonspecific expenses and total plant in service, (4) uncollectible revenue on an uncollectible revenue per access line basis, (5) quality of service comparisons, (6) capital structure comparison, (7) comparison of embedded cost rates and market rates of recent debt issues and current bond ratings, (8) cash flow statement, and (9) United's progress in converting from electromechanical switching to digital switching as provided in its response to Staff Data Request Item Number 36.

Staff recommended that

> [i]f adopted, the Commission will review United's filing on an annual basis. If, in the Commission's opinion, the Company has made a sufficient showing of improved or increased efficiencies or productivity, the Company would be allowed to continue to operate under incentive regulation. If so, under the plan approved by Order No. 90-849 in Docket No. 90-266-C, dated September 5, 1990, the Company may retain additional earnings up to [a threshold of] 100 basis points above the Commission approved benchmark and would share earnings on a 50/50 basis up to 250 basis points above the threshold.
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> (TR. Vol. 2, p. 178, lines 5-17).

Consumer Advocate witness Buckalew testified that the Commission should require United to make additional filings. Specifically, Mr. Buckalew testified that United should be required to file an annual embedded direct cost analysis for major service categories; that United not price any service below its marginal cost; that United present a list with supporting documentation of its services which are subject to the competitive market; that United submit a total factor productivity study on an annual basis similar to the plan implemented in Georgia; and that the 50% of the "sharings" of earnings between the threshold and the ceiling going to the ratepayers should be applied towards additional investment in technology rather than by issuing refunds. Finally, Mr. Buckalew recommended that the incentive plan should exclude exogenous factors from the plan which have more than a 10 basis point impact on the overall rate of return.

AT&T witness Mertz testified that if the situation of "sharings" of earnings develop (i.e. between the threshold and the ceiling), United should be required to identify rate decreases for intrastate access charges as a priority. Mr. Mertz explained that this form of reduction is "critical if South Carolina customers are to enjoy the benefits that lower cost toll services bring." (TR., Vol. 2, p. 94, lines 14-15).

The Commission has considered the recommendations of the parties and has determined that Staff's guidelines, as proposed, should be utilized by the Commission in evaluating United's performance under the earnings sharing plan. As determined earlier, exogenous factors will be excluded when the Commission reviews a company's performance under incentive regulation. Consequently, the Commission adopts the nine (9) productivity guidelines recommended by the Staff. In addition, the Commission concludes that the embedded direct cost analysis requirement recommended by the Consumer Advocate should also be approved. The Commission finds that this analysis will aid in the determination of whether or not there is any cross subsidization as a result of the Company's operations under an earnings sharing plan. The guidelines adopted herein are attached hereto as Appendix A.

The Commission, however, concludes that United should not be required to present a list with supporting documentation of its services which are subject to the competitive market. As noted earlier in this Order, in its generic proceeding addressing the concept of incentive regulation, the Commission found that every LEC is affected by competition. Further, the Commission has found that in this proceeding United has established the impact of competition on its operations.

The Commission denies the Consumer Advocate's request that United submit a total factor productivity (TFP) study on an annual basis similar to the plan implemented in Georgia. At this time, insufficient information is available to the Commission to make an appropriate judgment as to the usefulness of a TFP study. The Commission finds, however, that the Staff should monitor the progress of the plan in Georgia for future Commission consideration.

Further, the Commission denies the Consumer Advocate's recommendation that United be prohibited from pricing any service below its marginal cost. This Commission does not set rates based on a service's particular cost. Therefore, the Consumer Advocate's request concerning marginal cost pricing does not reflect current Commission pricing policy and should be denied.

The Commission has considered the parties' proposals regarding the various ways United could implement the sharing mechanism if additional earnings above the threshold are experienced after twelve months under the plan. The Commission notes there are merits to each of the suggestions. However, the Commission has determined that it will not make a decision at this time as to how any shared earnings will be treated in the future. The Commission is of the opinion that the level of earnings available to be shared is an important factor in considering how those dollars should be treated. Additionally, ratepayer needs, economic conditions, technological needs, and governmental requirements existing at the time of review would certainly impact any sharing decision. Therefore, the Commission will decide how earnings will be shared on an "after the fact" basis, giving due regard to the conditions existing at the time the earnings are reviewed.

Upon Commission approval of its filing to reduce its earnings to 12.50%, United will begin under this incentive regulation plan effective January 1, 1993.

VIII.

EARNINGS ABOVE BENCHMARK

After establishing the benchmark rate of return of 12.50%, the Commission has reviewed the earnings of the Company. Based on the Company's approved capital structure, embedded cost of debt as of June 30, 1992, and adjustments made to rate base, the Commission has determined that the Company's test year return on equity is 13.78%. The Commission finds that United should reduce its earnings down to the benchmark of 12.50%. Before its incentive regulation plan becomes effective, United should make an appropriate filing for the Commission's approval to reduce its earnings to the benchmark. This would require a revenue reduction of $650,316 by United. The Commission will require that the filing be noticed to the public, and the filing will be reviewed to determine the appropriate reduction in the Company's revenues. Upon Commission approval of its filing to reduce its earnings to 12.50%, United will begin under this incentive regulation plan effective January 1, 1993.

IX.

FINDINGS OF FACT

1. The Company is a corporation authorized to conduct a public utility business in the State of South Carolina. The Company is a wholly-owned subsidiary of Sprint Corporation.

2. The Company's present rates and charges were approved by Order No. 91-362, dated May 28, 1991, in Docket No. 89-229-C.

3. The Company owns and operates exchanges and lines

providing local exchange and intraLATA toll telephone service to access lines located throughout South Carolina.

4. The appropriate test period for the purposes of this proceeding is the twelve-month period ending December 31, 1991.

5. By its application, the Company is seeking to avail itself of incentive regulation by establishing a benchmark rate of return of 13.75% and is not seeking an increase in its rates and charges.

6. The appropriate operating revenues for the Company for the test year under the present rates and after accounting and pro forma adjustments are $34,501,546.

7. The appropriate operating expenses for the Company's intrastate telephone operations for the test year under its present rates and after accounting and pro forma adjustments are $28,581,599.

8. The Company's appropriate level of net operating income for return after accounting and pro forma adjustments is $6,025,095.

9. A year-end, original cost, South Carolina intrastate rate base of $50,131,691 consisting of the components set forth in Table A of this Order, should be adopted.

10. The capital structure utilized by the Commission in this proceeding for its determination of the Company's proper level of return on common equity is the consolidated capital structure of United Telephone System as of June 30, 1992.

11. That as of June 30, 1992, Staff's embedded cost rates of

8.90% and 6.79% for long-term debt and preferred stock, respectively, should be used in the determination of a fair, overall rate of return.

12. The reasonable rate of return on common equity that the Company should be allowed to earn is 12.50% which is adopted by the Commission for this proceeding. Combined with the debt and the capital structure set forth above, the Commission finds the reasonable, overall rate of return is 11.20%.

13. That United has met its burden of proof in this proceeding and will be allowed to avail itself of incentive regulation, effective January 1, 1993, subject to the conditions and restrictions set forth herein.

14. That United's authorized rate of return on equity of 12.50% shall be the established benchmark rate of return under the earnings sharing plan.

15. That the earnings floor will be 11.50%; the earnings threshold will be 13.50%; and the earnings ceiling will be 16.00%.

16. As long as United is operating under the earnings sharing plan, any earnings within the rate of return range of 11.50% to 16.00% that are the result of its efficiencies and productivity are just and reasonable.

17. Any additional earnings experienced by the Company above the benchmark not due to increased efficiencies and productivity will be refunded to the ratepayers.

18. To determine a company's "earnings" subject to retention by the company and/or sharing with its ratepayers, the earnings

will be evaluated before they are applied to the plan.

19. The Commission Staff's proposed guidelines and the Consumer Advocate's request for an embedded direct cost analysis are hereby adopted to evaluate the Company's efficiencies and productivity.

20. The total factor productivity analysis is not appropriate to use at this time, but the Commission reserves the right to require such if later found to be appropriate.

21. Exogenous factors will be excluded from the Commission's review of a company's performance under incentive regulation.

22. The Commission will consider how any earnings under this plan are to be shared during the Company's twelve month review proceeding.

23. That before United is authorized to operate under incentive regulation, the Company must file and have approved by the Commission a proposal to reduce its earnings to the benchmark rate of return of 12.50% and its level of revenues, expenses and net income to that indicated as appropriate herein.

IT IS THEREFORE ORDERED:

1. That United may operate under an incentive regulation trial as approved herein.

2. That the guidelines attached hereto as Appendix A are hereby adopted by the Commission and may be amended, modified, or changed as found appropriate by the Commission.

3. That United's benchmark rate of return is established at 12.50% return on equity.

4. That after United has operated under incentive regulation for a period of twelve months, its operations will be evaluated under the guidelines adopted by the Commission and its earnings will be assessed at that time.

5. That this Order shall remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:

Chairman

ATTEST:

Executive Director

(SEAL)

Arthur, dissenting. I respectfully dissent. Based on the testimony of record and the current economic conditions, I would set the rate of return on common equity at 12%. This return would be at the low end of the Staff witness' recommended range and at the high end of the Consumer Advocate witness Legler's recommended range.

INCENTIVE REGULATION GUIDELINES:

1. Provide operating expenses expressed on a cost per access line basis. This comparison should be filed adjusting the expense levels for inflation using the Consumer Price Index and also with no adjustment for inflation.

2. Provide a ratio between Plant Specific Expenses and the respective Plant Specific Asset Category.

3. Provide a ratio between Plant Nonspecific Expenses and Total Plant in Service.

4. Provide Uncollectible Revenue on an Uncollectible Revenue per Access Line Basis.

5. Provide a comparison of the trouble reports per hundred access lines, number of held applications for service exceeding thirty days, and the number of regrades exceeding thirty days.

6. Provide a comparison of the capital structure of the consolidated United Telephone System with capital structure of the individual Bell Operating Companies.

7. Provide a comparison of the interest rate on long-term debt issued by the consolidated United Telephone System during the last 12 months with the average utility bond yields reported by Moody's and/or Standard & Poor's for bonds of the same rating at the approximate date of issue.

8. Provide a comparison of cash flows to the parent corporation and Dividend Payout Ratios which reflect the flow of funds from United Telephone Company of the Carolinas to the parent company.

9. Provide a copy of the company's current Electromechanical to Digital Central Office Conversion Schedule. Include the number of access lines served by each Switching Center and the listing of central offices converted during the previous calendar year.

10. Provide an annual embedded direct cost analysis for each major service category.